

STATE OF CALIFORNIA
ELECTRICITY OVERSIGHT BOARD



Gray Davis, Governor

July 19, 2002

VIA ELECTRONIC DELIVERY FOR FILING

Hon. Magalie R. Salas, Secretary
Federal Energy Regulatory Commission
888 First Street, NE
Washington, D.C. 20426

**Re: California Independent System Operator Corporation,
Docket No. ER02-1656-000**

Dear Ms. Salas:

The Electricity Oversight Board hereby submits for filing electronically its Comments on the Proposed Revisions and Additional Elements of the Comprehensive Market Design Proposal of the California Independent System Operator Corporation.

Thank you for your assistance.

Sincerely,

/s/

Sidney L. Mannheim
Senior Staff Counsel
Electricity Oversight Board

cc: Official Service List of Docket Nos. ER02-1656

UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

California Independent System)
Operator Corporation)
_____)

Docket No. ER02-1656-000

**COMMENTS OF THE CALIFORNIA ELECTRICITY OVERSIGHT BOARD
REGARDING LONG-TERM ELEMENTS OF THE
COMPREHENSIVE MARKET DESIGN PROPOSAL OF THE
CALIFORNIA INDEPENDENT SYSTEM OPERATOR CORPORATION**

The California Electricity Oversight Board (“CEOB”) hereby files preliminary comments in the above-captioned proceeding in response to the Comprehensive Market Design Proposal (“MD02”) filed by the California Independent System Operator (“CAISO”) on June 17, 2002 (“Long-Term Elements Filing”). The Long-Term Elements Filing supplemented an earlier May 1, 2002, filing by the CAISO by including tariff revisions to address: (1) congestion management through adoption of a full network model and utilization of locational marginal pricing, (2) creation of an integrated day-ahead market, (3) reforms to hour-ahead and real-time markets, (3) an available capacity (“ACAP”) requirement, (4) and reforms to firm transmission rights (“FTRs”). The CAISO proposed to implement the long-term elements in the Spring and Fall of 2003, except for ACAP, which the CAISO proposed to implement as of January 1, 2004.

The May 1, 2002 filing included a description of all aspects of MD02, as well as tariff language concerning those design elements that the CAISO believed must be implemented upon expiration of the Commission’s existing mitigation measures on September 30, 2002. Those elements included: (1) locational market power mitigation,

(2) residual unit commitment (“RUC”), (3) modification of the must-offer requirement, (4) real-time economic dispatch, (5) use of a single energy bid curve, (6) uninstructed deviation penalties, (7) and other mitigation measures (“October 1 Elements”).

The CEOB filed detailed comments (in consultation a California inter-agency working group on market redesign¹) on the CAISO’s May 1, 2002 filing, including the long-term design elements. The Commission’s newly released *Order on the California Comprehensive Market Redesign Proposal*, issued on July 17, 2002 (“Redesign Order”), dramatically alters the landscape and renders comments on the CAISO’s June 17, 2002 largely irrelevant. The Redesign Order not only accepted, rejected and modified the October 1 Elements, it also approved the expedited implementation of certain long-term design elements. The Commission also directed the CAISO to file new proposals and tariff sheets by October 21, 2002, with respect to the creation of an integrated day-ahead market, implementation of a full network model and locational marginal pricing, and reforms to ancillary services, hour-ahead and real-time markets. Thus, the Redesign Order superseded the Long-Term Elements Filing, which no longer represents the next iteration for consideration and comment. The CEOB, therefore, hereby reserves the right to comment on the October 21, 2002, tariff changes in accordance with the Redesign Order.²

The Redesign Order also set for technical conference the proposed ACAP, FTRs and RUC requirements. The CEOB anticipates providing comments in preparation for,

¹ The working group is composed of staff members from the California Electricity Oversight Board, California Public Utilities Commission, California Energy Commission, Consumer Power and Conservation Financing Authority, and the California Energy Resources Scheduling division within the California Department of Water Resources.

² The CEOB does not by these comments intend to waive or otherwise limit its right to seek rehearing of any aspect of the Redesign Order.

and in response to, the scheduled technical conferences. Nevertheless, the CEOB feels compelled prior to the technical conference to express concern over the Commission's treatment, in particular, of the CAISO's ACAP proposal.

The CEOB supports the basic goals underlying the ACAP proposal - LSEs must resume the responsibility to serve load; the CAISO must be afforded a mechanism to verify in advance that adequate capacity is available to meet system load and reserves; operating decisions must move out of real-time; and appropriate economic incentives should be available to prompt investment in new generation. Despite these laudable goals, the ACAP proposal is fundamentally flawed.³ Equally significant, the Commission's decision in the Redesign Order to set ACAP for "expedited development" conflicts with the State and local authorities' recognized responsibility for in resource planning and the shared goal of restraining the exercise of market power in California.

In its Standard Market Design proposal, the Commission recognized the primary role of states in assuring resource adequacy.

Preferably, state and regional reliability authorities will coordinate with one another to set a regional, long-term reserve margin to be maintained by LSEs subject to their jurisdiction.⁴

Indeed, the Commission's deference to state jurisdiction in the Standard Market Design White Paper conforms with U.S. Supreme Court's recent decision acknowledging limits on federal jurisdiction:

³ The CEOB refers the Commission to the *Protest and Comments on ISO Market Redesign Proposal Submitted by the Public Utilities Commission of the State of California on Behalf of the State of California Inter-Agency Working Group*, May 30, 2002, pp. 28 – 48 for a detailed discussion of the defects in the current ACAP proposal.

⁴ *Working Paper on Standard Transmission Service and Wholesale Electric Market Design*, p. 24.

Final Rule will not affect or encroach upon state authority in such traditional areas as the authority over local service issues, including reliability of local service; ***administration of integrated resource planning and utility buy-side and demand-side decisions***, including DSM [demand-side management]; ***authority over utility generation and resource portfolios***; and authority to impose non-bypassable distribution or retail stranded cost charges.⁵

The Redesign Order violates the clear demarcation of federal and state roles by unilaterally forcing adoption of a capacity mechanism through the CAISO. It ignores the fact that the California Public Utilities Commission (“CPUC”) is diligently engaged in establishing guidelines for the procurement of electric energy, capacity and ancillary services by its major investor-owned utilities and the fact that state legislation (AB 57) is currently awaiting the Governor’s signature requiring a procurement planning process for all electrical corporations. A decision in the proceeding before the CPUC is expected in October 2002.⁶ The Commission recognizes that a resource adequacy proposal is a “fundamental pillar of any workable market design.” Yet, the Commission’s disregard of ongoing state processes threatens to place the pillar in a location that is unable to support the market structure by conflicting with state controlled decisions over resource diversification, cost recovery, demand response programs, and reserve margin requirements to ensure local reliability. The state proceedings must be allowed to run their course and only then, will it be reasonable and effective for LSEs and the CAISO to engage in a cooperative and collaborative planning process to assess regional resource adequacy.

⁵ *New York et al v. FERC*, No. 00568; argued October 3, 2001; decided March 4, 2002 (emphasis added).

⁶ CPUC Docket No. 01-10-024.

Moreover, unless the elements of competitive market already exist in California, which the Commission readily admits they do not, the stated intention to rush development of a resource adequacy plan will simply result in the transfer of market power from the spot markets to capacity markets. The Redesign Order notes that the CAISO is not prepared to implement an ACAP, or any alternative proposal, until January 2004. The Commission goes on to state that “[s]uch a delay, in our view, impedes market development and may undermine other attempts to improve market rules.” The clear implication is that the Commission intends to impose some form of capacity plan prior to January 2004. This would be disaster. As emphasized by the CAISO Market Surveillance Committee:

Given current supply and demand for generating capacity in the western US, it is very likely that in the short term, at least one entity is pivotal in the ACAP market. Consequently, the ACAP market is very likely to be subject to significant market power at time horizons shorter than the time necessary to sit a substantial amount of new capacity in California.

For all of these reasons, we strongly agree with the ISO’s perspective that an ACAP market is not practical over the short-term. Moreover, we believe that several of these factors call into question the viability of a workably competitive ACAP market over the 2-3 year forward market horizon without intervention by FERC to cap the prices paid to generation unit owners for providing local ACAP.⁷

Thus, the timeline originally proposed by the CAISO is not even viable.

Accelerating that timeline as the Commission now proposes would only serve to exacerbate the potential for a repeat of unjust and unreasonable prices paid by

⁷ *Comments of the Market Surveillance Committee of the California ISO on the Proposed October 1, 2002 Market Power Mitigation Measures*, <http://www.caiso.com/docs/2002/04/23/2002042311463517802.pdf> (April 22, 2002), p. 4.

California consumers because of the exercise of market power in its wholesale electricity markets.

The need for further discussion of an appropriate resource adequacy plan is manifest from a quick review of the detrimental likely consequences of the CAISO's current ACAP proposal. For instance, the penalty structure advanced by the CAISO for an ACAP shortfall is blatantly unjust and unreasonable. The penalty of \$50,000 per MW doubles if the LSE does not drop load to make up the ACAP shortfall. This means that an LSE with a shortfall of 3,000 MWs - such as a hypothetical residual net short in a high peak month - would face a \$300,000,000 for that month. If the LSE submits a decremental load bid, this penalty would be reduced to \$150,000,000 for that month. Paying \$150,000,000 for *not* using 3,000 MWs is, perhaps, more absurd. Given the draconian penalties contemplated by the CAISO, the financial stability of a deficient LSE could rapidly deteriorate impairing its creditworthiness. The spiral effect of damaged credit is well known to the California market and efforts should be taken to avoid such consequences where reasonable.

Nor has the CAISO clearly articulated curtailment protocol. For example, under the current proposal, an LSE will not be curtailed so long as it fulfills its ACAP obligation 100% in Day Ahead. This means that if it fills up to 98% Day ahead, and 100% hour ahead, and does not cause a problem in real time – but another LSE does – the first LSE still gets curtailed in Stage 1. This is true even if that LSE supplies additional capacity in real-time to avoid a Stage 3. The incentive then is to ignore what is happening in hour ahead and real-time and just focus on Day Ahead.

In addition, there is no clear resolution of the treatment of energy-limited ACAP resources. Under ACAP as proposed, an energy-limited resource must be bid into the day-ahead market if not scheduled by the LSE. Thus, the CAISO could dispatch an energy-limited resource procured by one LSE for the benefit of another LSE and exhaust the availability of that resource. The CAISO has failed to specify whether the first LSE is protected from both the financial impact and capacity deficiencies.

Finally, the CAISO proposal creates the need for “reserves on reserves.” A supplier is required to cover its ACAP obligation by bidding into BEEP. (RARP 4.1(B) – must offer supply into BEEP to cover for forced outage, or confront liability for uninstructed deviations). However, a supplier cannot bid into real-time unless it has first bid into the hour-ahead market. (31.4.1.2 – all energy bids for the imbalance energy market must first bid into the hour-ahead market.) Consequently, a supplier must bid very high to ensure it is not taken in the hour-ahead period but can be in real time, thus driving up hour-ahead prices. In addition, the supply could still be taken in the hour-ahead. The supplier, therefore, is unlikely to offer all of its output into ACAP. The Commission has recognized that capacity margins in California and the rest of the west are tight. It should not encourage a scheme that forces capacity to be withheld from the market.

In conclusion, it is readily apparent that ACAP itself is seriously flawed and that expediting its implementation would be a serious mistake. The CEOB requests that the Commission defer implementation of ACAP pending further discussions and consideration.

Dated: July 19, 2002

Respectfully submitted,

/s/ Grant A. Rosenblum

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CERTIFICATE OF SERVICE

I hereby certify that I have caused, or will cause, the foregoing document to be served upon each person designated on the official service list compiled by the Secretary for this proceeding, pursuant to Rule 2010(a) of the Commission's Rules of Practice and Procedure, on or about July 19, 2002.

Dated at Sacramento, California, this 19th day of July, 2002.

/s/

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